Petition

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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

CARNATION COMPANY, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTION PRESENTED

Whether a casualty insurance premium payment is deductible as an "insurance premium" for federal income tax purposes to the extent that the covered risks are assumed by a wholly owned subsidiary of the insured.

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CARNATION COMPANY, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The petitioner, Carnation Company,[1] respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit affirming the judgment of the United States Tax Court.

OPINIONS BELOW

The opinion of the court of appeals is reported at 640 F.2d 1010 and, as originally issued, is reprinted

[1] Carnation is the parent of an affiliated group that includes fifty-six wholly owned subsidiaries and seven affiliated companies (50 percent or greater ownership). The affiliated companies are listed at App. p. 41a.

at App. pp. 1a-5a.[2] The order of the court of appeals denying rehearing and correcting its opinion is not reported and is reprinted at App. pp. 6a-7a. The opinion of the Tax Court is reported at 71 T.C. 400 and is reprinted at App. pp. 8a-30a.

JURISDICTION

The judgment of the Court of Appeals for the Ninth Circuit was entered on March 6, 1981. A timely petition for rehearing was denied on May 13, 1981, and this petition for certiorari is filed within 90 days of that date. The court of appeals had jurisdiction under 26 U.S.C. § 7482, and the Tax Court had jurisdiction under 26 U.S.C. § 6214. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

If the payments involved in this case are insurance premiums, the federal income tax results are governed by sections 162, 904, 951, and 952 of the Internal Revenue Code of 1954 and sections 1.162-1 and 1.960-1 of the Treasury Regulations thereunder (26 C.F.R. Part 1).[3] Pertinent parts of those statutes and regulations are set out verbatim at App. pp. 31a-33a.

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[2] All references herein to "App." are references to the Appendix hereto.

[3] The parties agree that the outcome of the question presented will determine the outcome of the other questions raised by this litigation—whether the payment received by the petitioner's insurance subsidiary in connection with a reinsurance agreement is "subpart F income" under section 952 of the Internal Revenue Code of 1954, and whether that payment is income from foreign sources for purposes of the foreign tax credit limitation provided by section 904 of the Code.

STATEMENT OF THE CASE[4]

This case arises from the Commissioner's assessment of a 1972 federal income tax deficiency against Carnation, based upon the Commissioner's view that Carnation's insurance arrangement did not constitute an "insurance" transaction for federal income tax purposes to the extent that Carnation's risks were insured by its wholly owned subsidiary.

Carnation is a major processor and seller of food and other grocery products, by-products, and containers throughout the United States and in many foreign countries. Stip. (2) at R. 131. In 1971, Carnation formed Three Flowers Assurance Company, Ltd., under the laws of Bermuda, to carry on the business of insurance and reinsurance of various multiple line risks, including those of Carnation and its subsidiary and affiliated companies. Stip. (11)-(13) at R. 134. Carnation purchased Three Flowers common stock for $120,000 cash. The bona fide identity and business purpose of Three Flowers have not been questioned by the Commissioner in this litigation.

Also in 1971, Carnation obtained from American Home Assurance Company an insurance policy providing casualty insurance coverage for the over 125 manufacturing plants and other facilities owned or

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[4] These facts are taken from the Stipulation of Facts in the Tax Court, the Exhibits thereto, and admissions in the pleadings. All references to "R." are references to Volume I of the Transcript of the Record of the Tax Court proceedings, references to "Stip." are references to the Stipulation of Facts at R. 130-40, and all references to "Ex." are references to the Exhibits in the Tax Court. A more detailed statement of facts appears in the Tax Court opinion. See App. pp. 9a-14a.

operated by Carnation and its subsidiaries. Stip. (7), (8) & (21) at R. 132-33, 137. The annual premium was $1,950,000.[5] Thereafter, American Home reinsured 90 percent of the risks with Three Flowers. Stip. (23) at R. 138; Ex. 6-F. American Home remained primarily liable to Carnation under the policy, with a total risk exposure in excess of $70 million, and thus was required to pay Carnation's claims and look to Three Flowers for reimbursement. Stip. (25) at R. 138-39.

In conjunction with this reinsurance arrangement, Carnation agreed to capitalize Three Flowers to the extent of $3,000,000. Accordingly, Carnation and Three Flowers entered into an agreement whereby Carnation could be required, upon demand by Three Flowers, to purchase up to 288,000 additional shares of Three Flowers stock at a price of ten dollars cash per share. Together with the $120,000 cash paid by Carnation for Three Flowers stock, this provided Three Flowers with total capital resources of $3,000,000 at the outset. R. 5; R. 19; Stip. (23) at R. 138; Ex. 4-D.

In 1972, Carnation paid to American Home the annual premium of $1,950,000, and American Home paid 90 percent of that amount, or $1,755,000, to Three Flowers, pursuant to the reinsurance agreement between them. Both amounts were the product of arm's-length negotiations. Stip. (27)-(29) at R. 139. On its 1972 federal income tax return, Carnation deducted the entire $1,950,000 premium paid to

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[5] For convenience, the parties agreed to present the issue to the Tax Court as if the entire premium were deducted by Carnation, rather than by Carnation and those of its subsidiaries whose risks were also being insured. Stip. (22) at R. 137-38. Carnation and its subsidiaries filed separate federal income tax returns.

American Home. Stip. (31) at R. 139-40. The Commissioner, in his notice of deficiency, determined that $1,755,000 of the $1,950,000 was not deductible. Stip. (32) at R. 140.

Carnation filed a timely petition under section 7482 * with the United States Tax Court for redetermination of the tax deficiency assessed by the Commissioner. A single judge of the Tax Court, in an unreviewed decision, granted the Commissioner's motion for summary judgment, holding that the premium paid to American Home did not constitute a payment for "insurance" to the extent of the reinsurance with Three Flowers, because the reinsurance obligation of Three Flowers had been "neutralized" by Carnation's capitalization of Three Flowers. 71 T.C. 400, 409 (1978); see App. p. 20a.

Carnation brought a timely appeal under section 6214 to the United States Court of Appeals for the Ninth Circuit, which on March 6, 1981, upheld as "not clearly erroneous" the Tax Court's "finding" that the insurance risk was neutralized. See App. p. 4a. Carnation filed a timely petition for rehearing, pointing out that the Tax Court decision had resulted from a motion for summary judgment and thus had involved no "findings" of disputed facts. On May 13, 1981, the court denied rehearing, but "corrected" its opinion by systematically removing all references to findings of fact and the "clearly erroneous" standard. See App. pp. 6a-7a. For example, the "finding" regarding the neutralization of the insurance risk became a "holding as a matter of law,"

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* Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as in effect in 1972.

and, instead of describing that holding as "not clearly erroneous," the court simply said that the holding was "correct."

This petition for a writ of certiorari followed.

REASONS FOR GRANTING THE WRIT

A writ of certiorari should be issued in this case because the decisions below (1) violate the long-established fundamental principle of the independent identity of corporations prescribed by this Court in *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943), and (2) threaten the continued vitality of a major segment of the insurance industry.

1. The Decisions Below Violate the Holding of This Court in *Moline Properties*.

The resolution of the question presented depends upon the validity of Rev. Rul. 77-316, 1977-2 C.B. 53 (reproduced at App. pp. 33a-40a), which articulates the Commissioner's position in this litigation and was relied upon by the court of appeals. 640 F.2d at 1013; see App. p. 5a. Treas. Reg. § 1.162-1 states that "insurance premiums" are deductible under section 162 as ordinary and necessary business expenses. Rev. Rul. 77-316 holds that premiums paid directly or indirectly to a wholly owned subsidiary for "insurance" are not deductible, because "there is no risk-shifting or risk-distributing, and no insurance."

The analytical underpinning of this holding is that the parent and its subsidiaries, including an insurance subsidiary, "represent one economic family with the result that those who bear the ultimate economic burden of loss are the same persons who suffer the

loss." See App. p. 36a. Thus, the revenue ruling views such insurance arrangements between related corporations as a form of nondeductible "self-insurance."

The "economic family" concept of Rev. Rul. 77-316 violates this Court's holding in *Moline Properties* that a separate corporate identity must be respected for tax purposes unless it is "a sham" or "unreal" or "a bald and mischievous fiction"—manifestly not the situation in this case wherein the bona fide business identity and purpose of Three Flowers have not been challenged. In *Moline Properties*, this Court explained the corporate entity doctrine as follows:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains *a separate taxable entity*. (319 U.S. at 438-39 (footnotes omitted and emphasis added)).

While Rev. Rul. 77-316 cites *Moline Properties* and claims to reach a result that is consistent with that decision, the concept of an "economic family" is inherently inconsistent with the concept of treating separate corporations as separate entities for tax purposes. In truth, Rev. Rul. 77-316 is designed to deny a deduction within the "economic family" that would unquestionably be allowed if sought outside the "family"—namely, a deduction under section 162 for insurance premiums paid to an insurance company. This is the fallacy of Rev. Rul. 77-316. To deny a deduc-

tion which would otherwise be allowed, merely because the premium payment is made to a subsidiary, the Commissioner must ignore the rule of *Moline Properties.*

Exceptions to the doctrine of separate corporate entities have been limited to those specifically provided by Congress. In section 1501, Congress has permitted taxpayers to elect limited "economic family" treatment by filing consolidated income tax returns which eliminate the effects of certain intercompany transactions. In other areas, Congress has expressly imposed an "economic family" concept to prevent specific abuses. For example, loss transactions between, and the allocation of income and deductions among, related taxpayers are governed by sections 267 and 482. Since the Commissioner has not asserted violations of any such Code provisions, he has acted without authority by engrafting his own "economic family" concept on the tax laws.

Moreover, the reliance placed on *Helvering* v. *Le Gierse,* 312 U.S. 531 (1941), in Rev. Rul. 77-316 is entirely misplaced. In that case, this Court stated the principle that an "insurance" arrangement requires the elements of risk-shifting and risk-distributing. It held that the insurance risk was neutralized where an annuity contract was issued in conjunction with a life insurance contract and the total consideration received exceeded the face amount of the life policy. While the revenue ruling cites the general principle set forth in *Le Gierse,* the situations described in the ruling have no risk-neutralizing aspects. The conclusion in the ruling is based solely on the relationship among the members of the corporate family.

Similarily, the courts below relied on the parent-subsidiary relationship between Carnation and Three Flowers. Although they purported to apply the risk-neutralizing analysis contained in *Le Gierse,* they erroneously equated Carnation's capitalization agreement to the annuity contract in that case. By relying on the simple agreement by a parent company to purchase its subsidiary's stock, the courts below were doing nothing less than seizing on the essential characteristic of a corporate relationship. Thus, the decisions below violate the principle of separate corporate identity, announced by this Court in *Moline Properties,* in the same manner as the revenue ruling. These assaults on *Moline Properties* clearly call for this Court's review.[7]

2. The Issues Raised in This Case Are Critical to the Continued Vitality of an Important Segment of the Insurance Industry.

In recent years, United States companies have turned increasingly to the use of subsidiary and affiliated insurance companies for a number of recognized business purposes and advantages, including the ability to insure otherwise uninsurable risks, flexibility of policy terms and conditions, and smoother adjustment of claims. Foreign subsidiaries are often selected to take advantage of favorable insurance regulation climates and to gain access to international

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[7] The court of appeals obviously applied the wrong standard of review, believing that it was reviewing the Tax Court's "findings of fact," even though the Tax Court decision had resulted from a motion for summary judgment. See App. p. 4a. Although the court below implicitly admitted its error by "correcting" the text of its opinion (see App. pp. 5a-7a), there remains considerable doubt about the process by which its judgment was formed.

reinsurance markets. The use of reinsurance, through a United States primary insurer (such as American Home), is frequently an advantage, particularly where local law or other conditions require property or activities to be insured by a company qualified to do business in the jurisdiction.

The increased use of insurance subsidiaries was noted by a well-known insurance consulting firm, Risk Planning Group, Inc., when it devoted the entire January/February 1981 issue of its *Risk Management Reports* (Vol. VIII, No. 1) to a survey of this segment of the insurance industry. Three Flowers is one of more than a thousand foreign and domestic subsidiaries insuring the risks of related companies. Of the Fortune 500 Companies, 188 have insurance subsidiaries. The total capital and surplus committed to Western Hemisphere insurance subsidiaries in 1980 was an estimated $3.5 billion, and annual premium collections were an estimated $4-5 billion. While many of these insurance companies are wholly owned by one of the insured corporations, a significant number are owned by more than one. Some subsidiaries insure only the risks of related companies, and others insure various levels of outside risks.

The opinions of the courts below, which have already been severely criticized by commentators,[8] have caused great disruption in this growing segment of the in-

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[8] Curley & Wawro, "To What Extent Does Deductibility of Insurance Premiums Depend on Risk Shifting?" 53 *J. Taxation* 116 (1980); Ross, "Captive Insurance Companies: Recent Developments," *Tax Management Memorandum* 81-14 at 3 (July 13, 1981); Spector, "Captive Insurers and Corporate Entities: The *Carnation* Case Misses the Issue," 57 *Taxes* 313 (1979).

surance industry. Because these decisions are impossible to reconcile with the principle of *Moline Properties*, they place in doubt any insurance arrangement between related entities. Accordingly, the intervention of this Court, by the issuance of a writ of certiorari, is required.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit.

Respectfully submitted,

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APPENDIX

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Opinion of the United States Court of Appeals for the Ninth Circuit, as originally issued (unreported).

CARNATION COMPANY,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

No. 79-7218.

Argued and Submitted Feb. 2, 1981.
Decided March 6, 1981.

J. Patrick Whaley, Los Angeles, Cal., argued for petitioner-appellant; Musick, Peeler & Garrett, Los Angeles, Cal., David W. Richmond, Miller & Chevalier, Washington, D. C., on brief.

James A. Riedy, Washington, D. C., argued for respondent-appellant; Gilbert E. Andrews, Washington, D. C., on brief.

On Petition for Review of a Decision of the United States Tax Court.

Before WRIGHT and REINHARDT, Circuit Judges, and MURPHY, Senior United States District Judge.*

WRIGHT, Circuit Judge:

Carnation appeals the Tax Court's determination that its agreement with American Home Assurance Company (American Home) to the extent reinsured with a Carnation subsidiary was not "insurance" for tax purposes, and that payments made thereunder were not deductible as a business expense. We affirm.

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* Of the Southern District of New York.

I. FACTS

In August 1971, Carnation incorporated Three Flowers Assurance Co., Ltd. (Three Flowers) as its wholly owned Bermuda subsidiary. It created Three Flowers to insure and reinsure various multiple line risks, including its own and those of its subsidiaries. Three Flowers wrote insurance only for Carnation and its subsidiaries.

Early in September, Carnation made an initial capital contribution of $120,000.

On September 22, 1971, Carnation purchased a blanket insurance policy from American Home. On that day, Three Flowers contracted to reinsure 90% of American Home's liability under Carnation's policy. American Home ceded to Three Flowers 90% of the premium received from Carnation and Three Flowers paid American Home 5% commission plus reimbursement for premium losses.

As a result of the reinsurance contract, American Home was required to pay Carnation's claims and seek reimbursement from Three Flowers.

Prior to the consummation of the reinsurance contract, American Home expressed concern to Carnation about Three Flowers' ability to cover losses. Carnation refused to deliver its letter of credit or other guarantee but agreed to capitalize Three Flowers up to $3,000,000 at the election of Carnation or the request of Three Flowers.

In 1972, Carnation deducted as a business expense the entire premium paid to American Home ($1,950,000). It claimed the 90% ceded by American Home to Three Flowers ($1,755,000) as income of a controlled foreign corporation, and included that amount in the computation of its foreign tax credit.

Upon audit, the Internal Revenue Service (IRS) determined the 90% premium ceded to Three Flowers was not deductible as a business expense. It characterized it

as a capital contribution by Carnation to its subsidiary. The IRS also readjusted Carnation's foreign tax credit accordingly. It allowed deduction of the 10% premium paid to American Home and not ceded to Three Flowers.

The Tax Court, 71 T.C. 400, granted the IRS motion for summary judgment based on stipulated facts.

II. DISCUSSION

A. Standard of Review

Since opinions of the Tax Court reflect the exercise of special expertise, we do not overrule that court unless an unmistakable question of law so mandates. *Estate of Simmie v. CIR,* 632 F.2d 93, 94 (9th Cir. 1980). Factual findings of that court will not be disturbed unless clearly erroneous. *Thompson v. CIR,* 631 F.2d 642, 646 (9th Cir. 1980). The burden is on the appellant to show clear error. *Geneva Drive-In Theatre, Inc. v. CIR,* 622 F.2d 995, 997 (9th Cir. 1980).

B. Business Deductions

Insurance premiums are deductible as "ordinary and necessary business expenses." 26 U.S.C. § 162(a). The question is whether Carnation and American Home entered into an insurance agreement.

Although insurance is not defined by the Internal Revenue Code, the Supreme Court has established that "[h]istorically and commonly, insurance involved risk-shifting and risk-distribution." *Helvering v. Le Gierse,* 312 U.S. 531, 539, 61 S.Ct. 646, 85 L.Ed. 996 (1941). However,

> [a]mounts receivable as the result of transactions which involve at the time of their execution no actual insurance risk are not receivable as insurance . . . .

Seward's Estate v. CIR, 164 F.2d 434, 437 (4th Cir. 1947); *see also Le Gierse, supra.*

However, a deduction is not allowed for amounts set aside for self-insurance. *See Steere Tank Lines, Inc. v. United States,* 577 F.2d 279, 280 (5th Cir. 1978), *cert. denied,* 440 U.S. 946, 99 S.Ct. 1424, 59 L.Ed.2d 634 (1979); *Spring Canyon Coal v. Commissioner,* 43 F.2d 78 (10th Cir. 1930), *cert. denied,* 284 U.S. 654, 53 S.Ct. 33, 76 L.Ed. 555 (1931).

The focus of our inquiry, as in any incidence of taxation, is the substance of the transaction. *Commissioner of Internal Revenue v. Court Holding Company,* 324 U.S. 331, 334, 65 S.Ct. 707, 708, 89 L.Ed. 981 (1945). Petitioner's argument, that the existence of insurance depends on the status of the actors, sidesteps this issue. The separate corporate status of Three Flowers and Carnation has no bearing on whether Carnation shifted the risk to American Home or whether American Home shifted the risk to Three Flowers.

The Tax Court found that the three agreements between Three Flowers and American Home, Three Flowers and Carnation, and Carnation and American Home were interdependent. The key was that American Home refused to enter into the reinsurance contract with Three Flowers unless Carnation agreed to capitalize Three Flowers.

The interdependence of contracts is a factual finding. *Lowell v. Twin Disc, Inc.,* 527 F.2d 767, 770 (2d Cir. 1975). This finding was not clearly erroneous.

These related documents must be considered together. *Le Gierse, supra,* 312 U.S. at 540, 61 S.Ct. at 649. They show Carnation attempted to shift the risk of loss due to casualty. The agreements shifted 10% of the risk to American Home and purported to shift 90% to Three Flowers. At the request of Three Flowers or Carnation, Carnation would capitalize Three Flowers up to $3,000,000. The Tax Court's finding that these agreements neutralize the risk to the extent American Home reinsured with Three Flowers is not clearly erroneous.

We note that situation 2 in the Revenue Ruling 77-316, 1977-2 C.B. 53 is identical to the facts in our case. It states:

> Domestic corporation Y and its domestic subsidiaries paid amounts as casualty insurance premiums to M, an unrelated domestic insurance company. This insurance was placed with M under a contractual arrangement that provided that M would immediately transfer 95 percent of the risks under reinsurance agreements to S2, the wholly owned foreign "insurance" subsidiary of Y. However, the contractual arrangement for reinsurance did not relieve M of its liability as the primary insurer of Y and its domestic subsidiaries, nor was there any collateral agreement between M and Y, or any of Y's subsidiaries to reimburse M in the event that S2 could not meet its reinsurance obligations.

The ruling concludes there is no risk shifting or risk distribution with respect to the risks carried or retained by the wholly owned subsidiary. We reject Carnation's contention that the quoted portion of this ruling conflicts with recognition of the separate status of corporations.

C. Foreign Tax Credit

Income of a controlled foreign corporation is includable in the income of United States shareholders, 26 U.S.C. § 951, and in the computation of foreign tax credits. 26 U.S.C. § 904. This includes "income derived from insurance of United States risks." 26 U.S.C. § 953.

Carnation argues the premium paid by American Home to Three Flowers is income derived from insurance. We disagree.

Application of § 953 is predicated on the existence of insurance. The Tax Court's finding that the payment received by Three Flowers was Carnation's contribution to capital and not an insurance premium is not clearly erroneous.

AFFIRMED.

Order of the United States Court of Appeals for the Ninth Circuit Denying Rehearing and Correcting Opinion (unreported).

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 79-7218

CARNATION COMPANY, *Plaintiff-Appellant,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Defendant-Appellant.*

ORDER DENYING REHEARING AND CORRECTING OPINION

Before: WRIGHT and REINHARDT, Circuit Judges, and MURPHY, Senior District Judge.

The panel as constituted in the above case has voted to deny the petition for rehearing. Judges Wright and Reinhardt have voted to reject the suggestion for a rehearing en banc.

The full court has been advised of the suggestion for an en banc hearing, and no judge of the court has requested a vote on it. Fed. R. App. P. 35(b).

The petition for rehearing is denied and the suggestion for a rehearing en banc is rejected.

The opinion heretofore filed on March 6, 1981 is corrected in the following particulars:

1. Slip op., p. 664, section entitled *Standard of Review* is corrected to read as follows:

> Since opinions of the Tax Court reflect the exercise of special expertise, we do not overrule that court unless an unmistakable question of law so mandates. *Estate of Simmie v. CIR,* 632 F.2d 93, 94 (9th Cir. 1980).

2. Slip op. p. 665, the second complete paragraph (headnote 5) is deleted.

3. P. 665, the third full paragraph (headnote 6) is corrected to read:

> These related documents must be considered together. *LeGierse, supra,* 312 U.S. at 540, 61 S.Ct. at 649. They show Carnation attempted to shift the risk of loss due to casualty. The agreement shifted 10% of the risk to American Home and purported to shift 90% to Three Flowers. At the request of Three Flowers or Carnation, Carnation would capitalize Three Flowers up to $3,000,000. The Tax Court's holding as a matter of law that these agreements neutralize the risk to the extent American Home reinsured with Three Flowers is correct.

4. P. 665, the last paragraph, the opinion is corrected to read:

> Application of § 953 is predicated on the existence of insurance. The Tax Court's decision that the payment received by Three Flowers was Carnation's contribution to capital and not an insurance premium is correct.

Opinion of Judge Goffe, United States Tax Court.
71 T.C. 400 (1978)

CARNATION COMPANY, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

Docket No. 5793-76. Filed December 26, 1978.

Petitioner and an unrelated insurance company entered into an "insurance" agreement. Simultaneously, the unrelated insurance company "reinsured" 90 percent of its risk under that agreement with petitioner's wholly owned Bermudan subsidiary. However, before the unrelated insurance company would participate in the "reinsurance" agreement, petitioner had to give its wholly owned Bermudan subsidiary access upon demand to an additional $2,880,000 in capital contributions. Without regard to the demand agreement, petitioner's capital contribution to its wholly owned Bermudan subsidiary was $120,000. *Held,* to the extent that petitioner's risk was "reinsured" with its wholly owned Bermudan subsidiary, its risk of loss had not shifted, its agreement with the unrelated insurance company was not insurance, and its payment to the unrelated insurance company was not deductible as an ordinary and necessary business expense for insurance. *Helvering v. LeGierse,* 312 U.S. 531 (1941), followed. *Held, further,* amounts received by petitioner's wholly owned Bermudan subsidiary pursuant to such "reinsurance" agreement are not includable in petitioner's income under sec. 951, I.R.C. 1954. *Held, further,* amounts received by petitioner's wholly owned Bermudan subsidiary pursuant to such "reinsurance" agreement are not characterized as income from sources without the United States for purposes of sec. 904, I.R.C. 1954.

J. Patrick Whaley and *David W. Richmond*, for the petitioner.

Alan S. Beinhorn, for the respondent.

OPINION

GOFFE, *Judge:* The Commissioner determined a deficiency in the Federal income tax of petitioner for the taxable year 1972 in the amount of $823,632. This matter is before the Court on the parties' motions for summary judgment which were filed pursuant to Rule 121, Tax Court Rules of Practice and Procedure. Due to concessions, three issues remain for our decision:

(1) Whether petitioner is entitled to deduct as an ordinary and necessary business expense the entire amount paid to an unrelated insurance company as insurance premiums if such unrelated company thereafter reinsures 90 percent of the risk that it assumed under petitioner's policy with petitioner's wholly owned Bermudan subsidiary;

(2) Whether the amounts so received by petitioner's subsidiary, which is a controlled foreign corporation, constitute income derived from the insurance or reinsurance of United States risks under section 953, I.R.C. 1954,[1] or constitute contributions to capital under section 118; and

(3) Whether the amounts so received by that subsidiary are attributable to petitioner as subpart F income and are considered income from sources without the United States for purposes of computing petitioner's foreign tax credit limitation under section 904.

For the purpose of these motions, all of the facts have been stipulated. The stipulation of facts and the exhibits attached thereto are incorporated by this reference.

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[1] All section references are to the Internal Revenue Code of 1954, as amended.

Carnation Co. (hereinafter Carnation or petitioner) filed its Federal income tax return for the taxable year 1972 with the Office of the Internal Revenue Service, Fresno, Calif. For 1972, Carnation and its subsidiary corporations which were required to file Federal income tax returns each filed separate Federal income tax returns rather than a consolidated return.[2] Carnation, a Delaware corporation, had its principal office in Los Angeles, Calif., during 1972.

Petitioner processes and sells food and other grocery products both within and without the United States. As part of its overall operation, Carnation manufactures cans in sufficient quantity to supply substantially all of its own needs as well as the needs of certain other canners. As a function of these operations, petitioner owns more than 125 plants and other facilities which are located in the United States and Canada. Such facilities are subject to the usual risks of loss ordinarily covered by insurance, and many of such facilities are situated in locales subject to earthquakes.

Carnation maintains an insurance department which is staffed by its own employees. This department recommends to Carnation's management the type and amount of insurance coverage needed and its likely cost. The insurance department's recommendations are made after consultation with Fred S. James & Co., an insurance brokerage firm employed by petitioner to place Carnation's insurance coverage with carriers. For many years, part of Carnation's insurance was placed with American International Group, Inc. (hereinafter AIG).

On August 20, 1971, the board of directors of Carnation resolved to organize an insurance company in Bermuda to carry on the business of insurance and reinsurance of various multiple line risks including those of petitioner

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[2] Petitioner and its subsidiaries have filed separate Federal income tax returns at least since 1954.

and its subsidiaries. On August 26, 1971, Carnation caused Three Flowers Assurance Co., Ltd. (hereinafter Three Flowers), to be incorporated as petitioner's wholly owned Bermudan subsidiary. Three Flowers is a controlled foreign corporation within the meaning of section 957. Under an agreement dated September 1, 1971, Carnation's initial contribution to the capital of Three Flowers was the purchase of 120,000 shares of common stock at its par value of $1 per share. By the same agreement dated September 1, 1971, petitioner and Three Flowers agreed that, on demand of either of them, petitioner would purchase up to 288,000 additional shares of Three Flowers' common stock at $10 per share. Three Flowers therefore had access upon demand to $3 million in capital contributions from its parent.

Carnation purchased a blanket insurance policy from American Home Assurance Co. (hereinafter American Home), which is a member company of AIG, providing for 3 years of insurance coverage commencing September 22, 1971. Such policy provided coverage of up to $500,000 per loss arising out of any one event at any one location with a $10,000 per loss deductible. Covered events included fire, lightning, vandalism, malicious mischief, sprinkler leakage, flood, and earthquake shock. Except for a small portion which covered Canadian risks, the entire coverage pertained to property located within the United States.

Also effective September 22, 1971, American International Underwriters Overseas, Ltd., of Hamilton, Bermuda (hereinafter Overseas), agreed to be Three Flowers' managing agent in Bermuda. Overseas specializes in the management of Bermudan insurance companies and is a member company of AIG.

Also on September 22, 1971, Three Flowers contracted to reinsure 90 percent of American Home's liability under Carnation's policy. Article I of that agreement provided as follows:

> 1. The Company agrees to cede and the Reinsurer agrees to accept a 90% quota share part of all such

insurances issued by the Company. Such insurance shall exclude the following:

a. As respects vessels:

Losses, Damage, or Expenses caused by or resulting from capture, seizure, arrest, restraint or detainment, or the consequences thereof or of any attempt thereat, or any taking of the vessel by requisition or otherwise, whether in time of peace or war and whether lawful or otherwise; also losses, damages or expenses from all consequences of hostilities or war-like operations (whether there be a declaration of war or not), but the foregoing shall not exclude collision or contact with aircraft, rockets or similar missiles, or with any fixed or floating object (other than a mine or torpedo), stranding, heavy weather, fire or explosion unless caused directly (and independently of the nature of the voyage or service which the vessel concerned, or, in the case of a collision any other vessel involved therein, if performing) by a hostile act by or against a belligerent power, and for the purpose of the exclusion, "power" includes any authority maintaining naval, military or air forces in association with a power; also excluded, whether in time of peace or war, all losses, damage or expenses caused by any weapon of war employing atomic or nuclear fission and/or fusion or other reaction or radioactive force or matter; also losses, damage or expenses from the consequence of civil war, revolution, rebellion, insurrection, or civil strife arising therefrom, or piracy.

b. As respects other property:

Losses, damage or expenses from any consequence whether direct or indirect, of war, invasion, act of foreign enemy, hostilities (whether war be declared or not), civil war, rebellion, revolution, insurrection or military or usurped power.

> 2. The premium due the Reinsurer shall be its proportionate share of the net premiums (i.e., gross premium less cancellations and returns) less the commission specified in ARTICLE II(4).

American Home ceded to Three Flowers 90 percent of the premium received from Carnation. Three Flowers paid American Home a 5-percent commission based on net premiums ceded and reimbursed American Home for premium taxes. As a result of this reinsurance contract, American Home was liable to Carnation under the insurance policy described above and was required to pay claims made by Carnation under that policy; Three Flowers was required to reimburse American Home under the terms of their reinsurance contract.

Prior to the consummation of the reinsurance agreement between American Home and Three Flowers, American Home had expressed its concern to petitioner about the financial ability of Three Flowers to cover losses pursuant to the contemplated reinsurance agreement. American Home requested that petitioner deliver its letter of credit or other guarantee to American Home. Petitioner refused to do so. However, petitioner did represent that it would provide for the capitalization of Three Flowers up to $3 million. Therefore, petitioner and Three Flowers entered into the agreement dated September 1, 1971, and described above. There were no other agreements, written or oral, between Carnation and American Home or Carnation and Three Flowers with respect to the risks covered under petitioner's policy.

In November 1972, Carnation paid American Home $1,950,000 as the 1972 annual premium. In December 1972, American Home paid Three Flowers $1,755,000 pursuant to their reinsurance contract for 1972. The amounts so paid were the product of arm's-length negotiation.

For the taxable year 1972, petitioner deducted as an ordinary and necessary business expense the entire $1,950,000 premium paid to American Home. Petitioner, acknowledging that Three Flowers was a controlled foreign corporation for 1972, reported $1,647,216 of income earned by Three Flowers but attributable to Carnation by reason of subpart F. In computing its section 904 foreign tax credit limitation, Carnation included the $1,647,216 of subpart F income as income from sources without the United States.

Respondent determined that $1,755,000 of insurance premiums paid by Carnation to American Home, which equals the amount of premiums ceded by American Home to Three Flowers under their reinsurance agreement, was not deductible by Carnation as ordinary and necessary business expenses. Instead, respondent characterized the $1,755,000 payment as a contribution by Carnation to the capital of its subsidiary, Three Flowers. As a result of that recharacterization, respondent further determined that income of Three Flowers attributable to petitioner by reason of subpart F had been overreported. Respondent determined that the proper amount of such income was $50,616 rather than the reported amount of $1,647,216. As a result of the disallowed deductions and the decrease in subpart F income, respondent also redetermined petitioner's foreign tax credit. Specifically, in determining the section 904 foreign tax credit limitation, the amount of petitioner's taxable income from sources without the United States was reduced and the amount of petitioner's entire taxable income was increased, aggregately causing the section 904 limitation to be reduced and ultimately causing petitioner's foreign tax credit to be reduced in the amount of $781,793.[3]

While the organization of respondent's brief makes no clear distinction among them, four separate theories are

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[3] Respondent also increased Carnation's 1972 income by $1,158,852 by reason of certain adjustments conceded by petitioner and not in issue here.

advanced to support respondent's determination that petitioner is not entitled to deduct as an ordinary and necessary business expense the entire amount paid to American Home. First, citing *Helvering v. LeGierse*, 312 U.S. 531 (1941), and *Commissioner v. Treganowan*, 183 F.2d 288 (2d Cir. 1950), respondent argues that risk-shifting is an ingredient necessary to insurance; that to the extent petitioner's risk was "reinsured" with its own subsidiary, its risk was not shifted; and therefore, that 90 percent of petitioner's payment to American Home, which amount ultimately was received by petitioner's subsidiary, was not paid to American Home as a deductible insurance premium. Second, citing *Spring Canyon Coal Co. v. Commissioner*, 43 F.2d 78 (10th Cir. 1930), cert. denied 284 U.S. 654 (1931), and *Pan-American Hide Co. v. Commissioner*, 1 B.T.A. 1249 (1925), respondent contends that no deduction is allowed for amounts set aside as self-insurance; that to the extent petitioner's risk was "reinsured" with its own subsidiary petitioner was engaged in an indirect form of self-insurance; and therefore that 90 percent of petitioner's payment to American Home, which amount ultimately was received by petitioner's subsidiary, was an amount set aside for self-insurance and nondeductible. Third, respondent argues that 90 percent of petitioner's payment to American Home, which amount ultimately was received by petitioner's subsidiary, was not "paid or incurred" by petitioner within the meaning of section 162 because that amount remained within petitioner's economic family and under its practical control. Fourth, respondent contends that the grant of a deduction in respect of any expenditure is predicated on value being received in exchange for such expenditure; that nothing of value was received by petitioner in exchange for 90 percent of its payment to American Home because ultimately petitioner bore the risk of loss on all reinsurance of petitioner's risk with its subsidiary; and therefore that 90 percent of petitioner's payment to American Home was not a deductible insurance premium.

Concerning the determination that petitioner's subpart F income should be reduced for 1972, respondent argues that since 90 percent of petitioner's payments to American Home are not premiums paid for insurance, the amount received by Three Flowers is not income derived from reinsuring United States risks and therefore is not income attributable to Carnation by reason of subpart F. Respondent contends that it necessarily follows that the amount received by Three Flowers from American Home constitutes an indirect capital contribution by Carnation to Three Flowers pursuant to section 118.

Concerning the decrease in petitioner's foreign tax credit determined for 1972, respondent contends that the decrease is mandated by a reduction in the section 904 foreign tax credit limitation, which reduction results from denying the deduction by petitioner of 90 percent of its payment to American Home and from recharacterizing American Home's payment to Three Flowers as a contribution by Carnation to Three Flowers' capital pursuant to section 118.

Petitioner's first argument responds to the determination that only 10 percent of the amount petitioner paid to American Home is deductible as an ordinary and necessary business expense. Carnation points out that payments of the kind made by it to American Home usually are deductible as ordinary and necessary business expenses paid for the procurement of insurance. Petitioner correctly concludes that its relationship to Three Flowers and the reinsurance agreement between Three Flowers and American Home are the reasons behind respondent's determination. Petitioner then reasons that respondent's determination is necessarily premised on a conclusion that Carnation and Three Flowers are not separate entities and are considered as one for tax purposes. Relying on the absence here of a consolidated income tax return and authorities such as *Moline Properties v. Commissioner*, 319 U.S. 436 (1943),

petitioner argues that Carnation and Three Flowers are separate entities for tax purposes. Petitioner concludes therefore that the premise for respondent's determination is destroyed and that Carnation is entitled to deduct as an ordinary and necessary business expense the entire amount it paid to American Home.

We agree with petitioner that some of the language in respondent's brief suggests that Carnation and Three Flowers are not separate entities. Deciding whether related corporations are separate entities for tax purposes is a factual determination. *Bass v. Commissioner*, 50 T.C. 595, 602 (1968). See *Moline Properties v. Commissioner, supra* at 439. If a material fact is in issue here, the parties' motions for summary judgment must be denied. Rule 121(b), Tax Court Rules of Practice and Procedure. Respondent's brief sets forth four theories to support his determination that it was inappropriate for petitioner to deduct the entire amount it paid to American Home. These four theories, although commingled somewhat, merit separate consideration. We must decide whether all of respondent's theories are premised on a finding that Carnation and Three Flowers are not separate entities for tax purposes. In that light, we will analyze respondent's argument that *Helvering v. LeGierse, supra* (hereinafter *LeGierse*), controls the instant case.

In *LeGierse*, an elderly woman entered into two contracts with an unrelated insurance company. The first was a single premium life insurance policy naming her daughter as beneficiary. The second was a single premium lifetime annuity. The insurance company agreed to issue the insurance policy only on the condition that the elderly woman simultaneously would purchase the annuity.

Less than a month after the execution of the two contracts, the elderly woman died. Under section 302(g) of the applicable statute, the Revenue Act of 1926, "the excess over $40,000 of the amount receivable by [bene-

ficiaries other than the executor] as insurance under policies taken out by the decedent on his own life" was includable in the decedent's gross estate. The amount receivable by the decedent's daughter was $25,000. Before the Supreme Court, the issue was whether the proceeds were includable in the decedent's gross estate. As a preliminary issue, the Court decided whether the proceeds received by the decedent's daughter were "receivable * * * as insurance" and hence excludable from the decedent's gross estate under section 302(g). The Court analyzed the language and the apparent purpose of the statute and determined that the word "insurance" was used in section 302(g) in its commonly accepted sense. The Court observed that—

> Historically and commonly insurance involves risk-shifting and risk-distributing. * * * That these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators. * * * Accordingly, it is logical to assume that when Congress used the words "receivable as insurance" in section 302(g), it contemplated amounts received pursuant to a transaction possessing these features. * * * [312 U.S. 531, 539-540.]

The Court decided that the annuity and "life insurance" contracts were not distinct transactions and should be considered together in deciding whether an insurance risk existed. The Court reasoned that "annuity and insurance are opposites; in this combination the one neutralizes the risk customarily inherent in the other. From the company's viewpoint, insurance looks to longevity, annuity to transiency." 312 U.S. at 541. The Court concluded that the contracts exhibited no insurance risk and that the sum payable to decedent's daughter was not excludable under section 302(g) as an amount receivable as insurance.

The foregoing analysis of *LeGierse* reveals that the Court considered together two related agreements be-

tween unrelated parties. The Court's opinion is not premised on it disregarding the separateness of the parties to the agreements. We conclude that the application of *LeGierse* to the facts of the instant case will be equally valid whether or not Three Flowers and Carnation are separate entities for tax purposes. Therefore, petitioner's first argument fails to blunt respondent's argument that *LeGierse* controls the instant case. The next query is whether the application of *LeGierse* to the facts of the instant case supports respondent's conclusion that the agreements between Carnation and American Home and between American Home and Three Flowers were not insurance contracts for tax purposes. We have decided that *LeGierse* supports respondent's conclusion for the reasons set forth below.

The issue presented by the application of *LeGierse* to this case is whether an insurance relationship existed in 1972 between Carnation and American Home and between American Home and Three Flowers. The stipulation of facts here shows that the capitalization agreement between Carnation and Three Flowers, the insurance agreement between Carnation and American Home, and the reinsurance agreement between American Home and Three Flowers were not independently conceived or consummated. As a focal point, American Home refused to enter into a reinsurance agreement with Three Flowers unless Carnation agreed to provide for capitalization of Three Flowers in the amount of $3 million. As in *LeGierse,* the interdependence of the agreements is clear; following the approach taken by the Supreme Court in *LeGierse,* we must consider the agreements together.

By entering into the agreements in issue, Carnation attempted to shift its risk of property loss due to fire, lightning, vandalism, malicious mischief, sprinkler leakage, flood, and earthquake shock. The agreements attempted ultimately to shift 90 percent of the risk to

Three Flowers and 10 percent of the risk to American Home. In the event of a covered casualty, the loss suffered by Carnation ultimately would be borne 90 percent by Three Flowers and 10 percent by American Home. The agreement to purchase additional shares of Three Flowers by Carnation bound Carnation to an investment risk that was directly tied to the loss payment fortunes of Three Flowers, which in turn were wholly contingent upon the amount of property loss suffered by Carnation. The agreement by Three Flowers to "reinsure" Carnation's risks and the agreement by Carnation to capitalize Three Flowers up to $3 million on demand counteracted each other. Taken together, these two agreements are void of insurance risk. As was stated by the Court in *LeGierse*, "in this combination the one neutralizes the risk customarily inherent in the other." 312 U.S. at 541.

In *LeGierse*, the Court decided that no insurance risk existed and that a payment made by reason of the "insured's" death was not an amount receivable as insurance. In the instant case, we have decided that, to the extent American Home "reinsured" its risk with Three Flowers, no insurance risk exists. We hold that, considered together, the "reinsurance" agreement between American Home and Three Flowers is not insurance and the "insurance" agreement between Carnation and American Home is insurance only to the extent that American Home's risk under the policy was not "reinsured" with Three Flowers; 10 percent of the amount paid by Carnation in consideration for its agreement with American Home is deductible as an ordinary and necessary business expense for insurance premiums.[4]

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[4] Respondent determined that only 10 percent of the amount paid by Carnation in consideration for its agreement with American Home is deductible as an ordinary and necessary business expense for insurance premiums. Under the "reinsurance" agreement set forth in part above, Three Flowers agreed to assume 90 percent of

Petitioner attempts to avoid the application of *LeGierse* to the instant case by factual distinctions. Deciding whether an agreement is insurance under Federal statutes by reference to a risk-shifting test is not unique to tax controversies. See, e.g., *S.E.C. v. Variable Annuity Life Insurance Co.*, 359 U.S. 65 (1959). Under the Internal Revenue Code, the risk-shifting test has been applied when deciding whether agreements are insurance not only for purposes of the estate tax, as in *LeGierse*, but also for purposes of the income tax. See, e.g., *Haynes v. United States*, 353 U.S. 81, 85 (1957) (amounts received as sickness benefits); *Allied Fidelity Corp. v. Commissioner*, 572 F.2d 1190 (7th Cir. 1978); affg. 66 T.C. 1068 (1976) (fidelity and surety bond writing); *Tighe v. Commissioner*, 33 T.C. 557, 564 (1959) (proceeds from reciprocal partnership death benefit agreement). Thus, we are unmoved by petitioner's bald contention that the test used in *LeGierse* should not apply because it did not involve the writing of insurance by one corporation for another on the subsequent reinsurance of a portion thereof with a third corporation. The opinion of the Supreme Court in *LeGierse* controls the instant case.

Petitioner next contends that the "risk-shifting" and "self-insurance" arguments advanced here by respondent were rejected by this Court in *Theodore v. Commissioner*,

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the risk under American Home policies with Carnation exclusive of risks set forth in subpars. (a) and (b) of art. I, par. (1). Since certain risks were excluded from the 90-percent assumption, more than 10 percent of the risk likely was retained by American Home. However, since petitioner offered no argument to that effect nor provided proof regarding the true percentage of risk retained by American Home, we sustain respondent's determination that American Home retained a 10-percent risk, Carnation's risk of loss was shifted to that extent, and only 10 percent of Carnation's "premium" to American Home is deductible as an ordinary and necessary business expense. The burden of proof was on petitioner. *Welch v. Helvering*, 290 U.S. 111 (1933).

38 T.C. 1011 (1962), appeal dismissed by agreement of the parties (6th Cir. 1963), 1964 P-H par. 56324 (hereinafter *Theodore*). In *Theodore*, a taxpayer was a shareholder of two corporations. One was a taxicab company, the other an insurance company. The taxicab company insured its taxicabs with the insurance company. One issue in the case was whether the insurance company was a mutual insurance company. Another issue was whether under section 482 the premiums paid by the taxicab company to the insurance company were excessive. With respect to this second issue, respondent had disallowed a portion of the taxicab company's claimed deduction for insurance premiums as being excessive and correspondingly had decreased the income of the insurance company. As an alternative to his section 482 reallocation argument, respondent supported his determinations concerning the excessive portion under authority of *LeGierse* because there was no risk-shifting and under authority of *Spring Canyon Coal Co. v. Commissioner*, 43 F.2d 78 (10th Cir. 1930), cert. denied 284 U.S. 654 (1931), because the arrangement constituted a form of self-insurance.

We held that the insurance company was a mutual insurance company. We found that the amount paid by the taxicab company for insurance premiums was not excessive. We therefore allowed the taxicab company its deduction in full and charged the mutual insurance company with a corresponding amount of income. We did not mention respondent's "risk-shifting" and "self-insurance" arguments in our opinion, nor did we cite *Helvering v. LeGierse* or *Spring Canyon Coal Co. v. Commissioner, supra.*

Carnation argues that our decision in *Theodore* could not have been reached unless we rejected respondent's alternative arguments, which were the same risk-shifting and self-insurance arguments as those persented herein by

respondent. Carnation is correct, but such rejection did not indicate that respondent's arguments themselves were without merit. The risk-shifting and self-insurance arguments presented in *Theodore* were at variance with the pleadings in that case and inconsistent with respondent's determination there. Focusing on the application of *Le Gierse* in *Theodore*, it is apparent that if we had decided that *LeGierse* controlled the outcome of that case, then we would have recharacterized the insurance agreements between the insurance company and the taxicab company. Had we recharacterized the agreemeents as being other than insurance agreements, none of the amounts paid to the insurance company by the taxicab company would have been deductible as ordinary and necessary business expenses. Respondent did not argue that *LeGierse* required a complete disallowance of the premium deduction. Respondent did not try to recharacterize the company insuring the taxicabs as anything other than an insurance company. Respondent sought to disallow only that portion of the deduction that seemed excessive. Accordingly, respondent did not plead an increased deficiency under his alternative argument. That *LeGierse* would apply to the facts in *Theodore* and yet a portion of the deduction would be allowable as an amount paid for insurance is totally inconsistent. As presented in *Theodore*, the argument premised on *LeGierse* was blatantly inconsistent with respondent's overall position in the case, was defectively structured even as an alternative argument, and did not merit consideration or discussion. Similar defects do not exist here, and we have given respondent's arguments under *LeGierse* full consideration.

Petitioner further argues that, when related but separate corporate entities exist, respondent has at his disposal section 482 to ensure that transactions between such related entities reflect economic reality. A multitude of theories, including section 482, were available to respondent to attack the transactions in issue here. It is our task to

evaluate the arguments actually presented, not to decide whether alternative theories would have been more appropriate. Therefore, we reject petitioner's assertion that respondent should have proceeded otherwise. While we have rejected petitioner's assertion, we are sympathetic with its frustration over respondent's reluctance to explain the basis of his determination. The notice of deficiency sent to petitioner set forth the deficiency and the computations used to arrive at the deficiency. The Explanation of Adjustments sent to petitioner included the following cryptic paragraphs relative to the issues here:

> (a) It is determined that $1,755,000 of "insurance premiums" paid and deducted as a part of "other deductions" on your return is not deductible. Your taxable income is accordingly increased by $1,755,000.
>
> (b) It is determined that the Subpart F income from Three Flowers Assurance, Ltd. to be included in your taxable income is $50,616 rather than the $1,647,216 reported. Your taxable income is accordingly decreased by $1,596,600.

Respondent's answer to Carnation's petition was no more illuminating. While petitioner has neither challenged the validity of the notice of deficiency nor argued prejudice by reason of surprise, we admonish respondent with the following excerpt from *Commissioner v. Transport Mfg. & Equipment Co.*, 478 F.2d 731, 735 (8th Cir. 1973), affg. *Riss v. Commissioner*, 56 T.C. 388 (1971), and *Riss v. Commissioner*, 57 T.C. 469 (1971).[5]

> If a violation of a particular Internal Revenue Code section, Treasury regulation, or theory based on sections or regulations is involved, the Commissioner should notify the taxpayer of that section, regulation

[5] See *Abatti v. Commissioner*, T.C. Memo. 1978-392, 37 T.C.M. 1597, 1600, 1611-1612; 78 P-H Memo T.C. par. 78-392, 1589, 1601.

or theory. The failure to advise the taxpayer of such information is extremely prejudicial. Deficiency assessments are usually presumptively correct, and the taxpayer has the burden to prove them wrong.[6] The taxpayer works at an extreme disadvantage in trying to invalidate deficiency assessments if he does not specifically know why the Commissioner is challenging the taxpayer.[7] If the notice of deficiency does not state the reason for the deficiency, the Commissioner should then inform the taxpayer of the Code sections and theories in his answer. That is precisely the reason for the explicit provisions of Rule 14(b) of the Tax Court, which states:

> "(b) *Form of answer.* The answer shall be drawn so that it will advise the petitioner and the Court *fully* of the nature of the defense." (emphasis added.)

Fully advising the taxpayer includes recitation of the Code sections and theories on which the Commissioner relies.[8]

Petitioner goes on to argue that the theory under which respondent acts here, when applied to intercorporate dealings other than insurance, produces results inconsistent

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[6] Welch v. Helvering, 290 U.S. 111, 115, 54 S.Ct. 8, 78 L.Ed. 212 (1933); C.I.R. v. Riss, 374 F.2d at 166.

[7] In Commissioner v. Chelsea Products, 197 F.2d 620, 624 (3d Cir. 1952), the court said that "[t]he Taxpayer can hardly shoulder its burden if it does not know • • • which transactions or group of transactions the Commissioner has determined to have resulted in distortions of true net income."

[8] Of course, if a certain Code section, regulation or theory has not been specifically raised in the notice of deficiency, in the pleadings, or at trial and if there is an absence of surprise on the taxpayer's part, the taxpayer has no reason to complain. Nat Harrison Associates, Inc., 42 T.C. 601, 617 (1964).

with settled tax law. We have not yet addressed three of respondent's four theories. The theory that we have analyzed is founded on the Supreme Court's opinion in *Helvering v. LeGierse*, 312 U.S. 531 (1941). The concept central to *LeGierse* is that insurance possesses unique characteristics. *LeGierse* is a test to be applied to intercorporate insurance arrangements. We fail to see that *LeGierse* will have any application to other intercorporate dealings such as intercorporate inventory sales or asset sales, which was suggested by petitioner. In the context of *LeGierse*, petitioner's contention is a non sequitur. We need not test its correctness in the context of respondent's three other theories because it is unnecessary to consider respondent's alternative theories. We turn now to petitioner's final argument.

Section 951 provides for the inclusion of subpart F income in the income of United States shareholders. Section 952 defines subpart F income, one component of which is "the income derived from the insurance of United States risks (as determined under section 953)." Sec. 952(a)(1). Section 953 provides rules for determining that component.[6] Section 1.953-1(a), Income Tax Regs., provides in pertinent part as follows:

> (a) *In general.* The subpart F income of a controlled foreign corporation for any taxable year in-

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[6] SEC. 953. INCOME FROM INSURANCE OF UNITED STATES RISKS.

(a) GENERAL RULE.—For purposes of section 952(a)(1), the term "income derived from the insurance of United States risks" means that income which—

(1) is attributable to the reinsurance or the issuing of any insurance or annuity contract—

(A) in connection with property in, or liability arising out of activity in, or in connection with the lives or health of residents of, the United States, or

(B) in connection with risks not included in subparagraph (A) as the result of any arrangement whereby

cludes its income derived from the insurance of United States risks for such taxable year. * * * *It is imma-*

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another corporation receives a substantially equal amount of premiums or other consideration in respect to any reinsurance or the issuing of any insurance or annuity contract in connection with property in, or liability arising out of activity in, or in connection with the lives or health of residents of, the United States, and

(2) would (subject to the modifications provided by paragraphs (1), (2), and (3) of subsection (b)) be taxed under subchapter L of this chapter if such income were the income of a domestic insurance corporation.

This section shall apply only in the case of a controlled foreign corporation which receives, during any taxable year, premiums or other consideration in respect of the reinsurance, and the issuing, of insurance and annuity contracts described in paragraph (1) in excess of 5 percent of the total of premiums and other consideration received during such taxable year in respect of all reinsurance and issuing of insurance and annuity contracts.

(b) SPECIAL RULES.—For purposes of subsection (a)—

(1) In the application of part I of subchapter L, life insurance company taxable income is the gain from operations as defined in section 809(b).

(2) A corporation which would, if it were a domestic insurance corporation, be taxable under part II of subchapter L shall apply subsection (a) as if it were taxable under part III of subchapter L.

(3) The following provisions of subchapter L shall not apply:

(A) Section 809(d)(4) (operations loss deduction).

(B) Section 809(d)(5) (certain nonparticipating contracts).

(C) Section 809(d)(6) (group life, accident, and health insurance).

(D) Section 809(d)(10) (small business deduction).

(E) Section 817(b) (gain on property held on Decem-

terial for purposes of this section whether the person insured or the beneficiary of any insurance, annuity, or reinsurance contract is, as to such corporation, a related person or a United States shareholder. • • • [Emphasis added.]

Petitioner's final argument is that section 953 and the underscored portion of respondent's regulations contemplate a reinsurance arrangement like the one before us and that they characterize the amounts received by Three Flowers as income from the insurance or reinsurance of United States risks.[7] Petitioner's argument is without

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ber 31, 1958, and certain substituted property acquired after 1958).

(F) Section 832(c)(5) (certain capital losses).

(4) The items referred to in—

(A) Section 809(c)(1) (relating to gross amount of premiums and other considerations),

(B) Section 809(c)(2) (relating to net decrease in reserves),

(C) Section 809(d)(2) (relating to net increase on reserves), and

(D) Section 832(b)(4) (relating to premiums earned on insurance contracts),

shall be taken into account only to the extent they are in respect of any reinsurance or the issuing of any insurance or annuity contract described in subsection (a)(1).

(5) All items of income, expenses, losses and deductions (other than those taken into account under paragraph (4)) shall be properly allocated or apportioned under regulations prescribed by the Secretary.

[7] Petitioner has also cited Treasury Department draft legislation which antedates the enactment of subpart F and which includes in its version of sec. 953 reference, as in the underscored portion of respondent's regulations, to the insurance or reinsurance of risks of a related person or United States shareholder. Petitioner

merit. It is deficient in that it "places the cart before the horse." *LeGierse* is based on the principle that an agreement may resemble insurance in form yet lack an ingredient essential to insurance. The Supreme Court held that such an agreement may not be characterized as insurance and the proceeds therefrom may not be characterized as proceeds from insurance. Applying *LeGierse* to the facts stipulated by the parties here, we have decided that to the extent petitioner's risk was not shifted, the agreements in issue may not be characterized as insurance. To that extent, sections 952, 953, and the regulations thereunder have no application to the agreements here because the application of such sections is predicated upon the existence of insurance. We hold that the amount received by Three Flowers from American Home as premiums for "reinsurance" is not income derived from the insurance of United States risks within the meaning of sections 952 and 953. Absent any alternative argument by petitioner, we affirm respondent's determination under section 118 that the amount so received by Three Flowers is a contribution to capital. Similarly, we affirm respondent's determination that such amount does not constitute income from sources without the United States for purposes of the section 904 foreign tax credit limitation.

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has cited such draft legislation to buttress its argument that the arrangement before us was contemplated by Congress and must be characterized as insurance. We reject petitioner's contention. First, the language present in respondent's regulation and the cited draft does not appear in sec. 953 as enacted. Second, that language is not even mentioned in the House, Senate, or Conference committee reports. H. Rept. 1447, 87th Cong., 2d Sess. (1962); S. Rept. 1881, 87th Cong., 2d Sess. (1962); Conf. Rept. 2508, 87th Cong., 2d Sess. (1962). Third, even if taken at face value, the language found in the draft legislation and carried over to respondent's regulation does not support petitioner's inferential contention that the application of *Helvering v. LeGierse*, 312 U.S. 531 (1941), to sec. 953 is barred by such language.

Having decided under authority of *LeGierse* that respondent's determination is correct, we do not reach respondent's alternate contentions.

An appropriate order and decision will be entered.

STATUTORY PROVISIONS INVOLVED

Internal Revenue Code of 1954 (as in Effect in 1972)

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .

SEC. 904. LIMITATION ON CREDIT.

(a) Alternative Limitations.—

. . . .

(2) Overall Limitation.—In the case of any taxpayer who elects the limitation provided by this paragraph, the total amount of the credit in respect of taxes paid or accrued to all foreign countries and possessions of the United States shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

SEC. 951. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES SHAREHOLDERS.

(a) Amounts Included.—

(1) In General.—If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year beginning after December 31, 1962, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross

income, for his taxable year in which or with which such taxable year of the corporation ends—

(A) the sum of—

(i) except as provided in section 963, his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year . . . .

SEC. 952. SUBPART F INCOME DEFINED.

(a) In General.—For purposes of this subpart, the term "subpart F income" means, in the case of any controlled foreign corporation, the sum of—

(1) the income derived from the insurance of United States risks (as determined under section 953) . . . .

REGULATIONS INVOLVED

Treasury Department Income Tax Regulations (26 C.F.R. Part 1)

§ 1.162-1. Business expenses.

(a) *In general.* Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business . . . . Among the items included in business expenses are . . . insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business . . . .

§ 1.960-1. Foreign tax credit with respect to taxes paid on earnings and profits of controlled foreign corporations.

. . . .

(i) *Source of income and country to which tax is deemed paid*—(1) *Source of income.* For purposes of section 904—

(i) The amount included in gross income of a domestic corporation under section 951 for the taxable year with respect to a first-tier corporation or a second-tier corporation . . . shall be deemed to be derived from sources within the foreign country or possession of the United States under the laws of which such first-tier corporation, or the first-tier corporation of such second-tier corporation, is created or organized.

Revenue Ruling 77-316, 1977-2 C.B. 53.

Wholly owned foreign "insurance" subsidiary. Examples illustrate the tax consequences of so-called insurance premiums paid by a domestic corporation and its domestic subsidiaries to the parent's wholly owned foreign "insurance" subsidiary and compensation received from the foreign "insurance" subsidiary with respect to "insured" losses incurred by the domestic parent and subsidiaries.

Rev. Rul. 77-316

Advice has been requested whether, under each of the three situations described below, amounts paid as insurance premiums by a domestic parent corporation and its domestic susbidiaries to a wholly owned foreign "insurance" subsidiary of the parent are deductible as ordinary and necessary business expenses under section 162 of the Internal Revenue Code of 1954. Advice has also been requested whether deductions for losses that are incurred by the domestic parent and its domestic subsidiaries and that are otherwise allowable under section 165(a), will be reduced by amounts received from the "insurance" subsidiary. In addition, advice has been requested whether the wholly owned foreign "insurance" subsidiary in each situation described below qualifies as an insurance company for Federal income tax purposes.

Situation 1

During the taxable year domestic corporation *X* and its domestic subsidiaries entered into a contract for fire and other casualty insurance with *S1*, a newly organized wholly owned foreign "insurance" subsidiary of *X*. *S1* was organized to insure properties and other casualty risks of *X* and its domestic subsidiaries. *X* and its domestic subsidiaries paid amounts as casualty insurance premiums directly to *S1*. Such amounts reflect commercial rates for the insurance involved. *S1* has not accepted risks from parties other than *X* and its domestic subsidiaries.

Situation 2

The facts are the same as set forth in *Situation 1* except that domestic corporation *Y* and its domestic subsidiaries paid amounts as casualty insurance premiums to *M*, an unrelated domestic insurance company. This insurance was placed with *M* under a contractual arrangement that provided that *M* would immediately transfer 95 per-

cent of the risks under reinsurance agreements to *S2*, the wholly owned foreign "insurance" subsidiary of *Y*. However, the contractual arrangement for reinsurance did not relieve *M* of its liability as the primary insurer of *Y* and its domestic subsidiaries; nor was there any collateral agreement between *M* and *Y*, or any of *Y's* subsidiaries, to reimburse *M* in the event that *S2* could not meet its reinsurance obligations.

Situation 3

The facts are the same as set forth in *Situation 1* except that domestic corporation *Z* and its domestic subsidiaries paid amounts as casualty insurance premiums directly to *Z's* wholly-owned foreign "insurance" subsidiary, *S3*. Contemporaneous with the acceptance of this insurance risk, and pursuant to a contractual obligation to *Z* and its domestic subsidiaries, *S3* transferred 90 percent of the risk through reinsurance agreements to an unrelated insurance company, *W*.

Section 162(s) of the Code provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 1.162-1(a) of the Income Tax Regulations provides, in part, that among the items included in business expenses are insurance premiums against fire, storms, theft, accident, or other similar losses in the case of a business.

Historically, insurance involves risk-shifting and risk-distributing, and the sharing and distribution of the insurance risk by all the parties insured is essential to the concept of true insurance. See *Helvering v. Le Gierse*, 312 U.S. 531 (1941); *Commissioner v. Treganowan*, 183 F. 2d 188 (2d Cir. 1950); and Rev. Rul. 60-275, 1960-2 C.B. 43. Thus, when there is no economic shift or distribution of the risk "insured," the contract is not one of insurance,

and the premiums therefor are not deductible under section 1.162-1(a) of the regulations.

Also, both the Internal Revenue Service and the courts have long held that amounts set aside by a taxpayer as a reserve for self-insurance, though equal to commercial insurance premiums, are not deductible for Federal income tax purposes as "ordinary and necessary expenses paid or incurred during the taxable year." See Rev. Rul. 60-275, Rev. Rul. 57-485, 1957-2 C.B. 117, and *Pan American Hide Co. v. Commissioner,* 1 B.T.A. 1249 (1925). Even where a self-insurance fund is administered by an independent agent, such fact does not make payments to such fund deductible. See *Spring Canyon Coal Company v. Commissioners,* 43 F. 2d 78 (10th Cir. 1930), *cert. denied,* 284 U.S. 654 (1930).

Under the three situations described, there is no economic shifting or distributing of risks of loss with respect to the risks carried or retained by the wholly owned foreign subsidiaries, *S1, S2,* and *S3,* respectively. In each situation described, the insuring parent corporation and its domestic subsidiaries, and the wholly owned "insurance" subsidiary, though separate corporate entities, represent one economic family with the result that those who bear the ultimate economic burden of loss are the same persons who suffer the loss. To the extent that the risks of loss are not retained in their entirety by (as in *Situation 2*) or reinsured with (as in *Situation 3*) insurance companies that are unrelated to the economic family of insureds, there is no risk-shifting or risk-distributing, and no insurance, the premiums for which are deductible under section 162 of the Code.

Thus, the amounts paid by *X, Y,* and *Z,* and their domestic subsidiaries, and retained by *S1* (100 percent), *S2* (95 percent), and *S3* (10 percent), respectively, are not deductible under section 162 of the Code as "ordinary and necessary expenses paid or incurred during the taxable year." Because such amounts remain within the economic

family and under the practical control of the respective parent in each situation, there has been no amount "paid or incurred." See Rev. Rul. 60-275, and Rev. Rul. 69-512, 1969-2 C.B. 24.

However, in *Situation 2*, to the extent the unrelated insurer, *M*, retains the risks (5 percent) that are not reinsured by *S2*, and in *Situation 3*, to the extent *S3* transfers the risks (90 percent) through reinsurance agreements to *W*, the unrelated reinsurer, that portion of the premiums paid by *Y* and *Z* and their domestic subsidiaries to cover these risks are deductible under section 162 of the Code. Since these amounts are not withdrawable by either *Y* and its domestic subsidiaries or *Z* and its domestic subsidiaries, they have been "paid or incurred" within the meaning of section 162. Furthermore, the requisite shifting and distribution of the risks has occurred to the extent the unrelated insurers, *M* and *W*, respectively, bear the risks of loss.

Amounts paid as so-called insurance premiums by *X*, *Y*, and *Z*, and their domestic subsidiaries, with respect to risks remaining with *S1*, *S2*, and *S3*, respectively, will not constitute taxable income to *S1*, *S2*, and *S3* under section 61 of the Code as nothing has occurred other than a movement of an asset (cash) within each family of related corporations. Instead such amounts will be considered contributions of capital under section 118.

Because the parent through its control of the corporate family members (its domestic subsidiaries and its wholly owned foreign subsidiary) has control over the movement of assets within the family, the payments of so-called "insurance" premiums made by the domestic subsidiaries of *X*, *Y*, and *Z* to *S1*, *S2*, and *S3*, respectively, to the extent of available earnings and profits, are viewed first as a distribution of dividends under section 301 of the Code from such subsidiaries (equal to premiums paid that end up in the foreign "insurance" subsidiary) to their respec-

tive parents and then as a contribution of capital by the parents to the respective foreign subsidiaries. *Compare* Rev. Rul. 69-630, 1969-2 C.B. 112, discussing the treatment of a "bargain sale" between two corporate entities controlled by the same shareholders.

Furthermore, any proceeds paid by *S1*, *S2*, and *S3* to their respective parents or the parents' domestic subsidiaries with respect to risks of loss retained by *S1*, *S2*, and *S3* are viewed, to the extent of available earnings and profits, as distributions under section 301 of the Code to the respective parent. Specifically, proceeds paid by *S1*, *S2*, and *S3* to domestic subsidiaries of their respective parents are viewed, to the extent of available earninsg and profits, as distributions under section 301 to the respective parent followed by a contribution of capital from the respective parent to the domestic subsidiary.

The preceding analysis recognizes *S1*, *S2*, and *S3* as independent corporate entities in view of their business activities (*Moline Properties v. Commissioner*, 319 U.S. 436 (1943), 1943 C.B. 1011), but also examines the economic reality of each situation described. It is concluded that the "insurance agreement" with respect to the risks retained by *S1*, *S2*, and *S3* is designed to obtain a deduction by indirect means that would be denied if sought directly.

The second issue relates to whether any loss otherwise allowable to *X*, *Y*, and *Z* and their respective domestic subsidiaries under section 165 of the Code would be reduced by the proceeds received from *S1*, *S2*, and *S3* to the extent such payments are with respect to risks retained by *S1*, *S2*, and *S3*. Section 165(a) provides as a general rule that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Consistent with the reasons given above in denying the deduction of the amounts paid as insurance premiums by

X, *Y*, and *Z* and their respective domestic subsidiaries, any benefits paid by *S1*, *S2*, and *S3* to their respective parents and affiliates could not qualify as compensation by insurance or otherwise to the extent they result from the risks remaining with *S1*, *S2*, and *S3*. Accordingly, *X* and its domestic subsidiaries in *Situation 1* are entitled to a deduction under section 165(a) of the Code for any losses sustained during the taxable year, since the losses are not compensated by insurance or otherwise. *Y* and its domestic subsidiaries in *Situation 2* are entitled to a deduction for losses sustained during the taxable year to the extent not compensated for by insurance (that is, not compensated by insurance relating to risks assumed by *M*). *Z* and its domestic subsidiaries in *Situation 3* are entitled to a deduction for losses sustained during the taxable year to the extent not compensated for by insurance (that is, not compensated by insurance relating to risks reinsured by *W*).

The final issue is whether *S1*, *S2*, or *S3* qualifies as an insurance company for Federal income tax purposes. Section 1.831-3(a) of the regulations (applicable generally to stock casualty insurance companies) provides, in part, that the term "insurance companies" means only those companies that qualify as insurance companies under the definition provided by section 1.801-1(b), predecessor to section 1.801-3(a).

Section 1.801-3(a) of the regulations defines an insurance company for purposes of subchapter L as follows:

> The term "insurance company" means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry

on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.

The question, therefore, is whether *S1*, *S2*, and *S3* are primarily and predominantly engaged in the insurance business, either by virtue of their assuming a portion of the risks of their respective parents and the parents' domestic subsidiaries, or on the basis of business it transfers for reinsurance with unrelated insurance companies. Since the arrangement whereby *S1*, *S2*, and *S3* assume a portion of the risks of their respective corporate families is not insurance under the standards set forth in *Le Gierse*, such an arrangement does not constitute the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies as stated in section 1.801-3 (a) of the regulations. Also, *S3* is not engaged in the business of insurance by transferring the risks of its parent corporation and affiliates to an unrelated insurance company because, under a reinsurance agreement, there will be no shifting to or assumption by *S3* of any risk constituting insurance. See Rev. Rul. 56-106, 1956-1 C.B. 313, for the proposition that an insurance company that disposes of its insurance business under a reinsurance agreement ceases to be an insurance company on the effective date of the agreement and thereafter becomes taxable as an ordinary corporation.

Accordingly, *S1*, *S2*, and *S3*, as described above, are not insurance companies within the definition of section 1.801-3(a)(1) of the regulations because their primary and predominant business activity is not the issuing of insurance and annuity contracts or the reinsuring of risks underwritten by other insurance companies.

List Of Affiliated Companies

Bon Bon Company of America, Inc.

Carnation de Espana, S.A.

Carnation Philippines, Inc.

Laboratoires Vetrochimie, S.A.

"Societe Civile Immobiliere" BEL AIR

Solis Industrias de Alimentacion, S.A.

Carnation Foods Company, Ltd.

Opposition

Office - Supreme Court, U.
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No. 81-265

In the Supreme Court of the United States

OCTOBER TERM, 1981

CARNATION COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner seeks review of the decision below in this federal income tax case holding that payments that it made to an independent insurance company, but which were simultaneously ceded to petitioner's wholly-owned foreign subsidiary in return for its "reinsurance" of the risks primarily insured by the independent company, were not casualty "insurance" premiums and therefore could not be deducted by petitioner as a business expense under Section 162 of the Internal Revenue Code of 1954 (26 U.S.C.). As a result of this ruling, the courts below further held: (1) that the income of petitioner's subsidiary from "insurance of United States risks," a component of petitioner's "subpart F income" pursuant to Sections 951-953 of the Code, should be reduced to the extent that the "reinsurance" payments did not constitute "insurance" premiums; and (2) that petitioner's allowable foreign tax credit should be reduced

under the limitations of Section 904 of the Code because of the reduction in petitioner's "subpart F" income from foreign sources.[1]

The pertinent facts may be summarized as follows: Petitioner is a large corporation engaged in the food processing business. During 1972, the taxable year at issue, petitioner operated, directly and through subsidiaries, more than 125 facilities throughout the United States and Canada. Upon the recommendation of its insurance adviser, petitioner organized a wholly-owned foreign subsidiary, Three Flowers Assurance Company, Ltd. Three Flowers was capitalized at $120,000, with the intention of having the subsidiary insure a substantial portion of petitioner's casualty risks. Pursuant to this plan, petitioner purchased insurance from the American Home Assurance Company and American Home contracted to reinsure 90% of its liability with Three Flowers. Approximately 90% of the premiums paid by petitioner to American Home were transferred to Three Flowers. To ensure that Three Flowers would be able to indemnify American Home in the case of claims under petitioner's insurance policy, American Home entered the reinsurance arrangement only upon petitioner's agreement to provide Three Flowers with additional capital. Petitioner and Three Flowers therefore entered into a capitalization agreement giving Three Flowers access to $2,880,000 of petitioner's capital upon demand (Pet. App. 1a-7a).

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[1]The Commissioner took the position that because petitioner's indirect payments to its wholly-owned subsidiary were not insurance premiums, they were capital contributions which did not generate income to the subsidiary. Section 118 of the Code. Petitioner did not alternatively argue that if the payments were not deemed deductible insurance premiums they should be characterized other than as capital contributions. Cf. Ross, Baker & McKenzie, *Captive Insurance Companies: Recent Developments*, Tax Management Memorandum 81-14, at 3, 9 n.46 (July 13, 1981) (cited hereinafter as Tax Management).

For its taxable year 1972, petitioner deducted as an ordinary and necessary business expense the entire $1,950,000 "insurance premium" it paid that year to American Home. American Home paid $1,755,000 to Three Flowers as "reinsurance premiums," which petitioner treated as generating income from the insurance by Three Flowers of "United States risks," thereby increasing petitioner's "subpart F" income, and increasing its allowable foreign tax credit. See Sections 901, 904, 951-953 of the Code.

On audit, the Commissioner of Internal Revenue determined that $1,755,000 of the $1,950,000 in premiums paid by petitioner to American Home (the amount that was ceded by American Home to petitioner's wholly-owned subsidiary in return for its reinsurance of a proportionate percentage of the risks primarily insured by American Home) were not premiums on "insurance." Accordingly, the Commissioner disallowed petitioner's deductions, decreased its "subpart F" income, and reduced its allowable foreign tax credit, pro tanto. In this proceeding brought by petitioner in the Tax Court for redetermination of the deficiency, the Tax Court upheld the Commissioner's position, on the authority of this Court's decision in *Helvering* v. *LeGierse*, 312 U.S. 531 (1941). In so ruling, the Tax Court concluded that there was no "insurance" to the extent the policy petitioner placed with American Home was reinsured by petitioner's wholly-owned subsidiary because there was, to that extent, no shifting and distribution of petitioner's casualty risks. The court of appeals affirmed (Pet. App. 1a-6a).

1. The decision below correctly held that the payments paid by petitioner in the triangular "insurance" transaction were not deductible insurance premiums. In *Helvering* v. *LeGierse, supra*, the Court defined insurance transactions as those involving "an actual 'insurance risk' at the time the

transaction was executed," explaining that "[h]istorically and commonly insurance involves risk-shifting and risk-distribution" (312 U.S. at 539). Here, the courts correctly determined that because petitioner's triangular transaction viewed as a whole did not shift its casualty risks to an insurer, but was rather an elaborate form of self-insurance, the portion of petitioner's premiums ceded to petitioner's wholly owned subsidiary did not constitute premiums on "insurance." Accord: *Steere Tank Lines, Inc.* v. *Commissioner*, 577 F. 2d 279 (5th Cir. 1978), cert. denied, 440 U.S. 946 (1979).

2. Petitioner does not challenge the continued validity of the "insurance" concept first elaborated in *LeGierse*. Rather, petitioner argues that its application here is contrary to this Court's decision in *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943), which petitioner characterizes as holding that (Pet. 7) "a separate corporate identity must be respected for tax purposes unless it is 'a sham' or 'unreal' or 'a bald and mischievous fiction.' " But *Moline Properties* does not speak to the issue in this case, where the Commissioner is not seeking to disregard the separate identities of a corporation and its sole shareholder, but is merely characterizing a corporation's indirect payments to its wholly-owned subsidiary as something other than "insurance" premiums.

At all events, petitioner's argument fails because it addresses only one aspect of the *LeGierse* insurance concept, *i.e.*, the presence of risk-shifting. *LeGierse* established that insurance involves not only risk-shifting, but risk-distribution (312 U.S. at 539-540). Thus, even if the Commissioner were barred from treating petitioner and Three Flowers as members of one economic family for the purpose of testing whether petitioner's casualty risks had been shifted to an independent "insurer," petitioner's indirect

payments to Three Flowers still would not qualify as "insurance" premiums, because petitioner's triangular arrangement did not involve any distribution of petitioner's casualty risks. This follows from the fact that petitioner's casualty risks (except for the 10% insured by American Home without reinsurance) were borne by petitioner's subsidiary, a company whose business activities consisted exclusively of bearing the casualty risks of its parent company, *i.e.*, petitioner. See Rev. Rul. 78-338, 1978-2 Cum. Bull. 107; Rev. Rul. 80-120, 1980-1 Cum. Bull. 41. In this regard, the decision below would be correct even if Three Flowers were treated as a wholly independent company, because the absence of risk-distribution in the arrangement would preclude the characterization of Three Flowers' business activity as "insurance." *Allied Fidelity Corp.* v. *Commissioner*, 572 F. 2d 1190, 1194 (7th Cir. 1978), aff'g 66 T.C. 1068 (1976), cert. denied, 439 U.S. 835 (1978); *Commissioner* v. *Treganowan*, 183 F. 2d 288, 291 (2d Cir.), cert. denied, 340 U.S. 853 (1950).

Because there was no risk-shifting and risk-distribution to the extent that 90% of petitioner's casualty risks were borne by a subsidiary not engaged in the insurance of any other company's casualty risk, petitioner's indirect payments to Three Flowers were nothing more than payments to an elaborate self-insurance reserve.[2] Such payments

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[2] In *Commissioner* v. *Treganowan*, *supra*, 183 F. 2d at 291, the court quoted with approval the following comment, explaining the significance of risk-distribution in determining the existence of "insurance":

> Risk shifting emphasizes the individual aspect of insurance: the effecting of a contract between the insurer and insured each of whom gamble on the time the latter will die. Risk distribution, on the other hand, emphasizes the broader, social aspect of insurance as a method of dispelling the danger of a potential loss by spreading its cost throughout a group. By diffusing the risks through a mass of separate risk shifting contracts, the insurer casts his lot

cannot be characterized as "insurance" premiums, and of course they are nondeductible. See *Spring Canyon Coal Co.* v. *Commissioner*, 43 F. 2d 78 (10th Cir. 1930), cert. denied, 284 U.S. 654 (1931). The fact that petitioner's self-insurance reserve was not a mere accounting entry but was structured as a separate corporation does not alter the nature of the *contractual* arrangement between Three Flowers and petitioner. The absence of risk-shifting and risk-distribution in that arrangement precludes its treatment as "insurance," regardless of the degree of Three Flowers' alleged independence.[3] Indeed, once petitioner's payments are characterized as not being insurance premiums under *LeGierse*, the holding in *Moline Properties* virtually compels respondent's characterization of petitioner's indirect payments to Three Flowers as contributions to capital, along with the other tax consequences resulting from the recognition of Three Flowers' separate corporate existence. See Rev. Rul. 77-316, 1977-2 Cum. Bull. 53.

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with the law of averages. The process of risk distribution, therefore, is the very essence of insurance.' Note, the New York Stock Exchange Gratuity Fund: Insurance That Isn't Insurance, 59 Yale L.J. 780, 784 [1950].

[3]There was no finding below that Three Flowers' separate existence was not a "sham" or "unreal". Rather, petitioner's argument concerning the recognition of Three Flowers' separate corporate identity is premised on the peculiar procedural posture of this case. The Tax Court upheld the Commissioner's determination on the parties' cross-motions for summary judgment. As the Tax Court noted (Pet. App. 17a), because the question whether related corporations are separate entities for tax purposes is a factual determination, any decision that rested upon such a determination would be inappropriate for summary judgment. The Tax Court was not called upon to determine whether Three Flowers' existence could in fact be disregarded as a sham, because its decision for the Commissioner was compelled, as a matter of law, by the application of *LeGierse*.

3. Petitioner suggests (Pet. 9-11) that the opinions below have been "severely criticized by commentators" and have "caused great disruption" in a "growing segment of the insurance industry" involving the use of insurance subsidiaries, affiliated insurance companies, and foreign reinsurance arrangements. But the decisions below in no way limit the use of foreign reinsurance arrangements, or the establishment of closely held insurance affiliates, as long as the requisite elements of risk-shifting and risk-distribution are present. See Rev. Rul. 78-338, *supra*; Rev. Rul. 80-120, *supra*. This is clearly explained by one of petitioner's cited commentators. Tax Management *supra* at 10. Indeed, this "critical" commentary concludes (*ibid.*) that the decision below simply reaffirmed several well-established principles, *i.e.*—

> that merely labeling a transaction as insurance will not be determinative of its character for tax purposes and [that] the use of a fronting company will not necessarily insulate subsequent reinsurance transactions from scrutiny in determining the tax treatment of the insured * * * [and that] purported insurance arrangements may be closedly [sic] evaluated to determine whether some mechanism requires the insured to bear its own losses.

These propositions are hardly novel or controversial. *Helvering* v. *LeGierse*, *supra*; *Gregory* v. *Helvering*, 293 U.S. 465 (1935); *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945).[4]

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[4]The other commentators cited by petitioner lend no greater support to its position. Curley & Wawro, *To What Extent Does Deductibility of Insurance Premiums Depend on Risk Shifting?*, 53 J. Tax. 116 (1980); Spector, *Captive Insurers and Corporate Entities: The Carnation Case Misses the Issue*, 57 Taxes 313 (1979). The former commentators attack the fundamental validity of the *Le Gierse* concept of insurance as

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

OCTOBER 1981

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necessarily involving risk-shifting, a criticism not advanced by petitioner. The latter commentator, who is identified as an associate with a law firm representing petitioner, makes the point that if petitioner and Three Flowers were considered wholly separate entities, then the triangular arrangement would in fact have entailed risk-shifting from petitioner to its subsidiary. However, neither article addresses the critical absence of risk-distribution in petitioner's triangular "insurance" arrangement.

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Petitioner's Reply Brief

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No. 81-265

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

CARNATION COMPANY, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

REPLY MEMORANDUM FOR THE PETITIONER

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REPLY MEMORANDUM FOR THE PETITIONER

The decision below erroneously applied the risk shifting requirement of *Helvering* v. *Le Gierse*, 312 U.S. 531 (1941), in a manner that violates the principle of independent corporate identity set forth in *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943). The Commissioner's memorandum in opposition to the petition makes only a superficial attempt to defend the court of appeals' misapplication of the risk shifting requirement. He relies, instead, on the alternative argument that the petitioner's insurance arrangement fails to satisfy the risk *distribution* requirement of *Le Gierse*. This alternative argument rests on a factual supposition that is flatly contradicted by the record in this case.

1. The Commissioner argues (Mem. in Opp. at 4) that, under *Le Gierse*, petitioner's insurance arrangement "did not shift its casualty risks to an insurer, but was rather an elaborate form of self-insurance." That argument, however, hinges on the Commissioner's underlying premise — embraced by the court of appeals (Pet. App. at 4a-5a) — that a corporation and its subsidiaries

are a single "economic family" (Pet. App. at 36a) within which insurance risks cannot effectively be shifted for purposes of *Le Gierse*.

The Commissioner makes no real effort to reconcile the result below with the holding in *Moline Properties* that the separate identity of related corporations must be respected. He merely asserts (Mem. in Opp. at 4) that "characterizing a corporation's indirect payments to its wholly-owned subsidiary as something more than 'insurance' premiums" does not conflict with this principle. The foundation for his characterization of the payments, however, is the relationship between the corporations, in clear conflict with *Moline Properties*.

2. In an effort to postpone his inevitable collision with *Moline Properties*, the Commissioner argues that the risk shifting issue is not squarely presented here because petitioner's insurance arrangement fails in any event to satisfy the risk *distribution* requirement of *Le Gierse*. Mem. in Opp. at 4-5. The issue of risk distribution was not addressed by either court below. Moreover, this position is based on the erroneous assumption that the "business activities [of petitioner's subsidiary] consisted exclusively of bearing the casualty risks of its parent company, i.e., petitioner." Mem. in Opp. at 5. The record in this case shows, however, that the insurance subsidiary also insured the risks of various other subsidiary companies of the petitioner. Stip. (22) at R. 137-38.[1] Thus, the court's definition of risk distribution in *Commissioner* v. *Treganowan*, 183 F.2d 288, 291 (2nd Cir.), *cert. denied*, 340 U.S. 853 (1950), relied on by the Commissioner

[1] The stipulation states: Petitioner and Respondent have entered into a "Memorandum of Understanding" which, for purposes of presenting the issue involved herein in a convenient manner, deems that the entire 1972 premium was deducted by Petitioner rather than by it and those of its subsidiary companies whose risks were also being insured under the policy with American Home.

(Mem. in Opp. at 5, n.2), is satisfied in this case. Petitioner's insurance subsidiary dispelled "the danger of a potential loss by spreading its cost throughout a group" composed of the petitioner and its subsidiaries. Only by disregarding those separate corporate entities, contrary to *Moline Properties*, could the Commissioner assert a lack of risk distribution.

3. Finally, the Commissioner asserts that the decisions below will not disrupt the insurance industry because they do not limit insurance transactions "as long as the requisite elements of risk-shifting and risk-distribution are present." Mem. in Opp. at 7. But that assertion clearly begs the issue, because the threat to the industry arises from the manner in which the courts below applied the principle of risk shifting in the context of related corporate entities. The Commissioner obviously intends to continue applying his concept of risk shifting and risk distribution, which is based on his "economic family" doctrine. Thus, more than a thousand similarly situated insurance subsidiaries with annual premium collections estimated at $4-5 billion will be adversely affected. Pet. at 10.

For the reasons stated in its petition, petitioner respectfully submits that a writ of certiorari should issue.

Respectfully submitted,

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